<u>International Financial System (11/9/2010)</u> Econ 310-004

<u>Definitions</u>

- ***fixed exchange rate*** – a currency's value is matched to the value of another single currency or to a commodity (e.g., gold)
- ***floating exchange rate*** – a currency's value is allowed to fluctuate to the foreign exchange market
- ***managed float (dirty float)*** – floating ER: but government sometimes intervenes (buying or selling foreign assets to influence exchange rates)
- ***gold standard*** – fixed ER: currencies pegged to gold
- ***Bretton Woods*** – (1944-1971) fixed ER: dollar pegged to gold, other currencies pegged to dollar
- ***currency board*** – fixed ER: domestic currency backed 100% by a foreign currency with a permanent peg
- ***dollarization*** – fixed ER: adoption of a foreign currency as the domestic currency (e.g., the dollar)
- ***currency union*** – fixed ER (inside): countries join together for a common currency, which operates like a fixed regime (dollarization) among member countries and either fixed or floating with rest of the world
- ***capital controls*** – restrictions on foreign investment; restrictions regulating the flow in and out of the capital account
- ***perfect capital mobility*** – no capital controls
- ***impossible trinity*** – a country cannot have all 3 of the following at the same time: fixed exchange rate, capital mobility, independent monetary policy
- ***international reserves (foreign exchange reserves)*** – central bank holdings of assets denominated in a foreign currency
- ***foreign exchange interventions*** – central bank international financial transactions made to influence foreign exchange rates
- ***unsterilized foreign exchange intervention*** – FEI that effects the monetary base
- ***sterilized foreign exchange intervention*** – FEI with an offsetting open market operation that leaves the monetary base unchanged
- ***devaluation*** – setting the exchange rate peg (e) to a higher level
- ***revaluation*** – setting the exchange rate peg (e) to a lower level
- ***speculative attack*** – the massive selling (shorting) of a country's currency assets, with the hope of a devaluation, which would net a huge profit
- ***balance of payments (BoP)*** – net movement of funds between a nation and a foreign country
- ***current account (CA)*** – net movement of goods and services between a nation and a foreign country
- ***trade balance (TB)*** – exports minus imports
- ***capital account (financial account, FA)*** – net movement of capital (assets) between a nation and a foreign country
- ***International Monetary Fund*** – setup under Bretton Woods to help countries maintain fixed exchange rates (loans to countries with BoP problems); now acts as an international LOLR during financial crises
- ***World Bank*** – provides long-term loans to developing countries for economic development projects

<u>Equations</u>

- BoP = CA + FA — Balance of Payments
- CA = TB + NFIA + NUT — Current Account
- TB = EX – IM — Trade Balance

Principles

- Fixed exchange rates make trade and investment between two countries on the same peg easy (minimize exchange rate risk).
- Floating exchange rates have a more flexible monetary policy and don't have to waste resources defending the peg.
- The United States and most other countries were on a fixed exchange rate regime until 1971 (first the gold standard, then Bretton Woods).
- In order to defend a fixed exchange rate, the central bank must intervene when the exchange rate fluctuates.
- When the domestic currency depreciates (e↑), the central bank must sell foreign assets (international reserves) to restore the old exchange rate.
    - If it runs out of reserves, it must either devalue or switch to a floating regime.
- When the domestic currency appreciates (e↓), the central bank must buy foreign assets (international reserves) to restore the old exchange rate.
    - Central banks may accumulate a lot of international reserves (e.g., China has > $2 trillion).

Exchange rate regimes

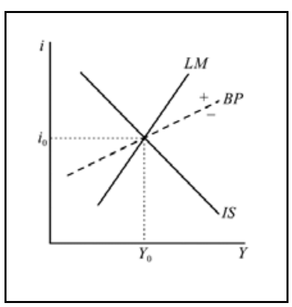
- gold standard (fixed)
- currency union (fixed inside)
- dollarization (fixed)
- currency board (fixed)
- traditional fixed (fixed)
- managed float (floating)
- pure float (floating)

Impossible trinity examples

- United states
    - ~~fixed exchange rate~~
    - independent monetary policy
    - capital mobility
- Euro (currency union)
    - fixed exchange rate
    - ~~independent monetary policy~~
    - capital mobility

Impossible trinity

Mundell-Fleming



perfect capital mobility

	float	fixed
FP	0	+
MP	+	0

no capital mobility

	float	fixed
FP	+	0
MP	+	0

unsterilized foreign exchange intervention

Assets		Liabilities	
FEX reserves	-$100	currency	-$100

sterilized foreign exchange intervention

Assets		Liabilities	
FEX reserves	-$100	currency	+$0
bonds	+$100		